United States Court of Appeals

for the Second Circuit

REPLY BRIEF

75-7203

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FOR THE SECOND CIRCUIT
NO. 212 - SEPTEMBER TERM, 1975
DOCKET NO. 75-7203

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PLS

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

v.

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

REPLY BRIEF OF STEINHARDT, BERKOWITZ & CO. AMICUS CURIAE

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REPLY BRIEF OF STEINHARDT, BERKOWITZ & CO. AMICUS CURIAE

PRELIMINARY STATEMENT

Following the decision and judgment herein, dated February 25, 1977 (the "Decision"), Steinhardt, Berkowitz & Co. ("SBC") petitioned this Court on March 22, 1977, for leave to appear as amicus curiae upon rehearing of this appeal and, at the time of its petition, filed its brief in support of the rehearing (the "SBC Brief"). On March 31, 1977, SBC was granted leave to appear and file its brief amicus curiae. Pursuant to an order of this Court, dated April 15, 1977, plaintiffs-appellants and the Securities and Exchange Commission (the "Commission")

as amicus curiae filed supplemental briefs (the "Appellants Brief" and the "Commission Brief", respectively) on the question of whether the general partners of defendant Fleschner Becker Associates ("FBA") were "investment advisers", within the meaning of the Investment Advisers Act of 1940, 15 U.S.C. 80b, et seq. (the "Advisers Act"). This brief is submitted in reply to the supplemental briefs.

POINT I

THE GENERAL PARTNERS OF AN INVESTMENT PARTNERSHIP DO NOT "ADVISE OTHERS", AND THUS ARE NOT INVESTMENT ADVISERS WITHIN THE MEANING OF THE ADVISERS ACT. NO SUBSTANTIAL AUTHORITY HAS BEEN CITED BY THE APPELLANTS OR THE COMMISSION TO THE CONTRARY AND THEIR POSITION ON THIS ISSUE IS UNSOUND AS A MATTER OF BOTH LOGIC AND POLICY

We have demonstrated that the general partners of FBA were not "investment advisers" for purposes of the Advisers Act because they are not "in the business of advising others" with respect to securities, within the plain meaning of the statutory definition (Advisers Act, Section 202(a) (11)). They are principals of a partnership which invests its own assets (SBC Brief, p. 4). In acting as principals for the partnership, the general partners are functionally in the same position as both the trustees of an investment trust (who have been held not to be investment advisers, by a district court in this Circuit, Selzer v. Bank of Bermuda Ltd., 385 F.Supp.

415 (S.D.N.Y. 1974), and by the Commission (In re Loring, 11 S.E.C. 885 (1942), SBC Brief, p. 9) and the internal managers of registered investment companies, who are not required to register as investment advisers (SBC Brief, p. 6). Neither the Commission nor the appellants cite any contrary authority.[1] Their efforts to distinguish away this precedent are based upon a misplaced emphasis on inapplicable portions of the legislative history[2] or upon factual distinctions which are not relevant.[3] The treatment of internal managers of regis-

1. The Commission Brief refers only to general language in the Commission's Institutional Investor Study Report, to two "no-action letters" (which the Commission concedes are "no precedent" at all), and to two articles. Commission Brief, p. 19, n.32. The appellants likewise rely only upon that Report and on "no-action letters". Appellants Brief, pp. 56-60.

2. With regard to Selzer, the Commission merely states that the "common sense meaning" approach of Judge Pollack conflicts with the Decision (which is the subject of this hearing) and speculates that the district court did not examine legislative history. Commission Brief, p. 13, n.21. The appellants do not criticize the "common sense meaning" approach, but similarly surmise that the district court was not aware of legislative history. Appellants Brief, pp. 24-25. However, as we shall demonstrate, it is a careful reading of legislative history which, in fact, further reinforces Judge Pollack's correct statutory reading (See discussion at Point II, infra, p. 6).

3. With respect to In re Loring, as well as to the other Commission actions cited by SBC (In the Matter of Roosevelt & Son and In the Matter of Pitcairn & Company) both the Commission and the appellants (Commission Brief, pp. 11-13; Appellants Brief, pp. 53-55) focus upon the form of these actions (exemptive orders) and upon factual distinctions (e.g., nature of compensation, acting by court appointment, limited size of entities, etc.) which do not affect their substance -- that trustees were simply not within the invest-

(footnote continued)

tered companies is simply ignored.[4]

Both the Commission and appellants argue that the general partners of FBA are investment advisers because they exercised discretion over the partnership's investments. They refer to an excerpt from a Senate Report to the effect that Congress intended the Advisers Act to cover "individuals and companies which either handle pools of liquid funds of the public or give advice with respect to security transactions..."[5]

Reliance upon this brief legislative excerpt is misplaced. Neither FBA, nor its general partners, "give advice"

(continued footnote)
ment advisory definition. In the opinion of one commentator, the Commission apparently determined (in Pitcairn) "consistently with its position in Loring, that the investment advice was not rendered to others". Lovitch, "The Investment Advisers Act of 1940 -- Who Is An Investment Adviser?", 24 Kan. L. Rev. at 89 (1975) (emphasis supplied), citing also In the Matter of Donner Estates, Inc., Advisers Act Release No. 21 [1941-44 Transfer Binder] CCH Fed. Sec. L. Rep. ¶75,216 (1941).

4. The Commission merely states, in effect, that advisers to registered investment companies coming within the Advisers Act definition are subject to that Act (Commission Brief, p. 15, n. 24). This general observation, however, simply fails to take into account the practice of its Staff, which has not required the internal managers of registered investment companies to register, notwithstanding the 1970 Advisers Act amendments requiring registration of all investment advisers to registered investment companies (SBC Brief, p. 6, n. 8). The only means of reconciling the Staff's practice with the statutory language is to conclude that the Staff has tacitly accepted the position, urged herein, that internal managers of investment companies are not "investment advisers" under the Advisers Act.

5. S. Rep. No. 1775, 76th Cong., 3d Sess. 21 (1940) (the "Senate Report"), cited in the Commission Brief, p. 6, n. 9, and the Appellants Brief, p. 8.

with respect to securities transactions.[6] On the other hand, if FBA handled "pools of liquid funds of the public", it would have been required to be registered as an investment company. It was exempt from such requirement because Congress provided an exemption (in Section 3(c)(1) of the Investment Company Act) when an investment company has less than 100 shareholders and is making no public offering of its securities. It cannot be logically argued that this specific exemption gives rise to a new requirement -- that those exempted from the Investment Company Act must be covered by the Advisers Act. But this is what the Commission and appellants ask this Court to hold, and they argue that the safeguards of the Advisers Act are required if the protections of the Investment Company Act are not available.

This is just not so. The safeguards of the Advisers Act are not necessary, and are pressed here because appellants have failed to seek their appropriate remedies under state law.[7]

6. Despite the claim by appellants (Appellants Brief, pp. 9 - 14), the "monthly reports" of the general partners of FBA remain functionally and substantively indistinguishable from financial reports sent out by countless issuers to their securities holders. It is urged that the question of whether the general partners of FBA are investment advisers must focus upon their principal activity -- that of managing the partnership's assets -- and not upon an incidental and routine function, such as reporting. As noted in the SBC Brief, every issuer, including investment companies, report to their security holders, and such reporting (which has the effect of assisting security holders to reach determinations to buy, sell or hold the issuer's securities) does not make the issuer's management "investment advisers."

7. Such remedies are clearly available (SBC Brief, p. 10, n. 13) and were not sought in plaintiffs' Complaint herein.

Like trustees, the general partners of FBA are bound both by express provisions of state law and by the highest fiduciary principles, far surpassing the narrow proscriptions of the Advisers Act. The Commission's response -- that Congress intended the Advisers Act to establish Federal fiduciary standards for investment advisers -- lacks firm substance.[8] It is especially suspect when one considers that banks, acting in their capacity as trustees, act as investment managers for huge portfolios (Morgan Guaranty Trust Company alone managing securities exceeding $15 billion, in 1975), without being subject to the "Federal fiduciary standards" of the Advisers Act.

POINT II

APPELLANTS AND THE COMMISSION HAVE FAILED TO PERCEIVE THE CLEAR CONGRESSIONAL INTENT TO EXEMPT PRIVATE INVESTMENT PARTNERSHIPS, AND THEIR GENERAL PARTNERS, FROM BOTH THE INVESTMENT COMPANY ACT AND THE ADVISERS ACT

The appellants and the Commission have brought absolutely no new legislative history to the attention of the

8. The Commission relies upon the Supreme Court's opinion in Santa Fe Industries, Inc. v. Green, ___ U.S. _____, 45 U.S. L.W. 4317 (March 23, 1977), which opinion cited (at 4320, n. 11) SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) (Commission Brief, pp. 8-9). Reliance on Santa Fe, of course, is particularly ironic, for there the Court refused to apply the Federal securities laws to a case involving "internal corporate mismanagement" (at 4322), a matter deemed adequately governed by state law. The Court cited Capital Gains to distinguish the decision, not to honor it. (It is submitted that Justice Harlan's dissent in Capital Gains (375 U.S. at 203) more accurately reflects the likely reluctance of the Court today to create a Federal body of fiduciary law under the aegis of the Advisers Act.) The holding in Capital Gains, moreover, appears to rest less upon any such recognized body of Federal law than upon common law standards of "equitable fraud", and thus would extend the Advisers Act no farther than the fiduciary law presently applicable to partners and trustees -- if, indeed, that far.

Court, choosing to ignore both the underlying hearings as well as the overall substance of the extensive report of the Commission[9] which was the cornerstone of the Advisers Act.

The SEC Report establishes that Congress did not intend internal managers of investment companies (whether registered or unregistered) to be "investment advisers": By that term, both the House and the Senate were referring specifically to the types of external, independent advisory firms and individuals, such as investment counsel, surveyed in the SEC Report.[10] It was the scope of the SEC Report which determined the substance of the Congressional intent -- and the Report, when read in its entirety, makes clear that officers and directors of self-managed investment companies (similar to FBA) were not regarded by the Commission (and thus ultimately not by Congress) to be investment advisers.[11]

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9. SEC, Report on Investment Trusts and Investment Companies (Investment Counsel, Investment Management, Investment Supervisory and Investment Advisory Services), H.R.Doc. No. 477, 76th Cong. 2d Sess. (1939) (the "SEC Report").

10. In the words of the Senate Report, "Title II, which deals with investment advisory services, is an outgrowth of the Commission's survey of these organizations..." (Senate Report at 20). The subsequent House Report similarly states, "Title II of the bill which deals with investment advisers is based on a survey of these organizations..." (H. Rep. No. 2639, 76th Cong., 3d Sess. at 27 (1940)) (emphasis supplied).

11. In the SEC Report, the Commission made clear that it was studying investment counsel firms supervising the portfolios of investment companies, "which were managed by persons or organizations other than the officers and directors of the investment companies". SEC Report, p. 9 (emphasis supplied). Moreover, the investment counselling firm was often at odds with the "internal managers" of an investment trust, thus further underscoring the distinction (See testimony of

(footnote continued)

The position that the general partners of FBA are not "investment advisers" is consistent with the exemption of FBA from registration as an investment company, and is not the "loophole" or "gap" asserted by the appellants and the Commission. Congress did not intend to exempt private investment companies under one part of a statute (Title I - the Investment Company Act), only to "recapture" its key personnel for regulation under the remaining part (Title II - the Advisers Act).

The Investment Company Act both provides an exemption for private investment companies, such as FBA, and confirms that their internal managers were not deemed by Congress to be investment advisers (SBC Brief, pp.4-9). As the Commission and appellants agree, there was no need to have overlapping regulation. There is also no need to nullify the Congressionally mandated exemption for private investment partnerships.

POINT III

SINCE APPELLANTS AND THE COMMISSION DO NOT DISAGREE WITH SBC'S POSITION THAT IT IS UNNECESSARY TO DETERMINE THE ISSUE OF WHETHER THE LIMITED PARTNERS OR THE PARTNERSHIP ITSELF ARE THE "CLIENTS" OF THE GENERAL PARTNERS, IT IS RESPECTFULLY SUGGESTED TH T THE COURT EITHER FIND THAT FBA IS THE "CLIENT" OR EXPRESSLY RESERVE THE "CLIENT" QUESTION

In the SBC Brief, we pointed out that even if it is held that the general partners are investment advisers, the

(continued footnote)
Theodore T. Scudder, at SEC Report, p. 14). Although many investment counsel firms had close affiliations with investment companies (SEC Report, p. 12, and Appendix D), by reason of common officers or directors, or stock ownership, all such firms were separate entities and not part of the companies' internal management.

Court need not determine that the limited partners were necessarily the "clients" of the general partners, for registration purposes,[12] since the anti-fraud provisions of Section 206 of the Advisers Act apply whether or not an investment adviser is required to be registered (SBC Brief, pp. 13-14). Both the Commission and the appellants have concurred in this view: Registration "is an issue that is not present in this appeal" (Commission Brief, p. 20; see also Appellants Brief, p. 36).

The Commission "does not disagree" with our view (SBC Brief, p. 11) that it was not necessary for the Court to conclude (Slip Op. at 6226, n. 16) that "the general partners as individuals, not FBA as an entity, were the investment advisers to the limited partners" (Commission Brief, p. 20, n. 34). We respectfully join in the Commission's suggestion that the underlined portion of this sentence in the footnote be deleted. Moreover, we respectfully suggest that the Court either find that FBA was the "client" of the general partners, or expressly state that it is making no determination as to whether the limited partners were "clients" for registration purposes. This would leave for the appropriate Commission or judicial setting the question of whether the "client" of the general partners of an investment partnership is, in general, the partnership itself or the limited partners.

12. General partners of investment partnerships, as well as other internal managers of investment vehicles, have relied, in part, upon the exemption from registration set forth in Section 203(b)(3) of the Advisers Act, exempting advisers having fewer than 15 "clients", on the basis that the partnership was its single client. As noted in the SBC Brief, this is a view recently followed by the Staff of the Commission in "no-action" correspondence (SBC Brief, p. 12, n. 18).

CONCLUSION

The basic question raised in this rehearing is whether the Advisers Act was intended to apply to the relationship between an issuer of securities and its management (FBA and its general partners) on the one hand, and its security holders (the limited partners), on the other. We think not. Statutory analysis of the companion statutes, the Advisers Act and the Investment Company Act, demonstrates this. The legislative history is consistent with this interpretation. And a common sense reading of the statutory definition of "investment adviser", as Judge Pollack correctly concluded, leads to the same result.

For the reasons set forth herein and in the SBC Brief, the Court should hold that the general partners of FBA are not "investment advisers" within the meaning of the Advisers Act. If the general partners are held to be investment advisers, the Court is urged either to find that the "client" of such advisers was FBA, not the limited partners, or otherwise to refrain from determining that the limited partners were "clients" of the general partners, as that term is used in Section 203 of the Advisers Act.

Respectfully submitted,

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May 13, 1977

CERTIFICATE OF SERVICE

Service of two copies of the annexed Reply Brief of Steinhardt, Berkowitz & Co. Amicus Curiae was made upon the following counsel for the parties and amici herein by placing same in the United States mail, postage prepaid, this 13th day of May 1977:

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